

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 422

September 21, 1982

INVESTMENT INTEREST EXPENSE LIMITATION: INDEBTEDNESS BEFORE 9/11/75

Syllabus:

Facts:

Revenue and Taxation Code Section 17203(d) provides for a limitation on the deduction of investment interest. The rules applicable to such investment interest deduction vary depending on whether the investment indebtedness giving rise to such interest was incurred prior to December 17, 1969, after December 16, 1969, but before September 11, 1975, or after September 10, 1975. The rules governing indebtedness attributable to a specific item of property incurred after December 16, 1969 but before September 10, 1975 are those in effect under Section 17203(d) prior to amendment at the 1977-78 Regular Session of the Legislature (see Section 17203(e)(3)).

Prior to such amendment, Section 17203(d), Revenue and Taxation Code, provided, in material part,

(d)(1) The amount of investment interest (as defined in subparagraph (D) of paragraph (3)) otherwise allowable as a deduction . . . shall be limited, in the following order, to --

(A) Twenty-five thousand dollars (\$25,000) (twelve thousand five hundred (\$12,500), in the case of a separate return by a married individual), plus

(B) The amount of the net investment income (as defined in subparagraph (A) of paragraph (3) . . . , plus

(C) An amount equal to the amount by which the total amount of capital gains recognized exceeds the total amount of capital losses recognized for the taxable year, plus

(D) One-half of the amount by which investment interest exceeds the sum of the amounts described in subparagraphs (A), (B), and (C).

(d)(3) For purposes of this subdivision --

(A) The term "net investment income" means the excess of investment income over investment expenses.

(B) The term "investment income" means --

- (i) The gross income from interest, dividends, rents, and royalties,
- (ii) The capital gain attributable to the disposition of property held for investment and held for not more than one year, and
- (iii) Any amount treated under Sections 18211 and 18212 to 18218, inclusive, as gain from the sale or exchange of property which is neither a capital asset nor property described in Sections 18181 and 18182 but only to the extent such income, gain, and amounts are not derived from the conduct of a trade or business.

* * *

(d)(5) The amount equal to the amount of investment interest which is allowable as a deduction by reason of subparagraph (C) of paragraph (1) of this subdivision shall be treated as gain from the sale or other disposition of property which is neither a capital asset nor property described in Sections 18181 and 18182.

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Questions:

1. For purposes of the limitation of investment interest expense on indebtedness attributable to a specific item of property incurred after December 16, 1969 and before September 10, 1975, are losses from capital assets held one year or less required to be netted against gains from such assets for purposes of Section 17203(d)(1)(B) or against capital gains as described in former Section 17203(d)(1)(C)?
2. When capital gains are used to increase the availability of investment interest from certain indebtedness incurred after December 16, 1969 and before September 10, 1975 and are thereby converted to ordinary income as a result of former Section 17203(d)(5), are gains from the sale of "nonproductive assets" and "small business stock" (Section 18161.5) also converted to ordinary income by that Section?
3. When the capital gains referred to in former Section 17203(d)(1)(C) are used to increase allowable investment interest deductions and are accordingly converted to ordinary income by operation of former Section 17203(d)(5), in what order are the gains from (1) assets held more than one year but not more than five (midterm assets), (2) assets held more than five years (long-term assets), (3) "nonproductive" assets described in Section 18161.5(b), and (4) "small business stock" described in Section 18161.5(a) applied for purposes of such conversion?

4. Are the untaxed gains from the sale of "nonproductive assets" and "small business stock" used to reduce the investment interest carryover available in subsequent years from indebtedness attributable to a specific item of property incurred after December 16, 1969 but before September 10, 1975, as required by former Section 17203(2)(B)(ii)?

5. Does California conform to the federal rule that the carryover of disallowed investment interest is denied to the extent that the disallowed investment interest exceeds the taxpayer's taxable income for the year?

Decisions:

1. Losses from capital assets held for one year or less are to be netted against similar gains from such assets for purposes of former Section 17203(d)(1)(B). Former Section 17203(d)(1)(C) does not apply to either gains or losses from capital assets held for one year or less.

2. Yes.

3. For the purpose of determining which capital assets are converted into ordinary income assets under former Section 17203(d)(5), the following mechanics are to be applied:

(a) Gains in each of the described classes are netted against losses in that respective class (if applicable).

(b) Net losses from the classes exhibiting such loss are totaled, then prorated against the gains in the remaining classes.

(c) The total investment interest allowed by operation of Section 17203(d)(1)(C) is then prorated against the net gains resulting from step (b) above.

4. Yes.

5. Yes.

Discussion:

Question 1

Gains from capital assets held one year or less (short-term gains) are included by definition in the amount referred to in Section 17203(d)(1)(B). See Section 17203(d)(3)(B)(ii). While the language of Section 17203(d)(3)(B)(ii) might appear to exclude losses from capital assets so held, failure to include such losses produces an anomalous result.

For example, if a taxpayer has \$100,000 in investment interest from indebtedness attributable to a specific item of property incurred after December 16, 1969 and before September 11, 1975 and \$25,000 in short-term capital gains and \$25,000 in short-term capital losses, an interpretation excluding short-term losses from Section 17203(d)(3)(B)(ii) would result in allowance of \$75,000 /1 in investment interest by operation of former Section 17203(d)(1).

If the short-term gains and losses were instead midterm or long-term capital gains and losses (i.e., gains and losses from capital assets held in excess of one year), a netting would be required under former Section 17203(d)(1)(C), and the investment interest expense allowed by operation of former Section 17203(d)(1) would be only \$62,500. /2

Moreover, the federal treatment of short-term capital gains and losses in the investment interest limitation computation requires a netting of such gains and losses for purposes of Section 163(d)(3)(B)(ii), IRC, which would result in allowable investment interest of \$62,500 by operation of former Section 163(d)(1), IRC, in effect for such indebtedness. Because former Section 17203(d) was adopted to conform to former Section 163(d), IRC, as originally enacted by P.L. 91-172, the results obtained under Section 17203(d) should follow the federal counterpart, if interpretation of the California provision will permit it.

Because statutes should be given a reasonable interpretation according to the intentions of the Legislature (58 Cal. Jur. Statutes Section 98), and a literal construction which will lead to absurd consequences should be avoided (58 Cal. Jur. Statutes Section 99), it is concluded that short-term gains in excess of short-term losses are included within the meaning of Section 17203(d)(3)(B)(ii).

/1 Former Section 17203

(d)(1)(A): \$25,000

(d)(1)(B): + 25,000

(d)(1)(C): + 0

(d)(1)(D): + 1/2 [100,000 - (25,000 + 25,000 + 0)]/\$75,000

/2 Former Section 17203

(d)(1)(A): \$25,000

(d)(1)(B): + 0

(d)(1)(C): + (\$25,000 - 25,000)

(d)(1)(D): + 1/2 [\$100,000 - (25,000 + 0 + 0)]/\$62,500

Because short-term gains and losses are included within the meaning of Section 17203(d)(3)(B)(ii) and therefore constitute a former Section 17203(d)(1)(B) item, it follows that short-term gains and losses cannot also constitute a former Section 17203(d)(1)(C) item, despite the language of Section 17203(d)(1)(C) item, which only generally refers to capital gains and losses. This is because inclusion in both Sections 17203(d)(1)(B) and 17203(d)(1)(C) would result in a double benefit if a taxpayer had only short-term capital gains. For the reasons stated above, there is nothing to suggest that the Legislature intended to confer a double benefit for short-term capital gains and provide for only a single benefit for midterm and long-term capital gains. (See also the discussion in Legal Ruling 378, CCH para. 205-173, P-H para. 58,626).

It is therefore concluded that short-term capital gains over short-term capital losses together constitute a Section 17203(d)(1)(B) item and such gains and losses do not constitute a former Section 17203(d)(1)(C) item.

Question 2

It is clear that the portions of Section 17203(d) that were repealed during the 1977-78 Legislative Session have current operative effect for indebtedness attributable to specific item of property incurred after December 16, 1969 and before September 11, 1975, (Section 17203(e)(3)). Therefore such provisions must be considered as being incorporated by reference in the current law, as though set out in full.

Former Section 17203(d)(1)(C) states that the amount by which the total amount of capital gains recognized exceeds the total amount of capital losses recognized shall be used to increase the available investment interest deduction. "Recognized" for this purpose means the gross gains and losses without regard to the reduction required by Section 18162.5. Legal Ruling 378, *supra*.

Because "nonproductive assets" and "small business stock," as defined by Section 18161.5, are capital assets, and because former Section 17203(d)(1)(C) is valid law with respect to indebtedness attributable to a specific item of property incurred after December 16, 1969 and before September 11, 1975, "nonproductive assets" and "small business stock" are former Section 17203(d)(1)(C) assets and gains on such assets are usable to increase the limitation on such indebtedness.

Former Section 17203(d)(5) provides that the amount of capital gains used to increase the available investment interest via former Section 17203(d)(1)(C) shall be considered ordinary income. Thus, to the extent that gains on "nonproductive assets" and "small business stock" are used to increase the allowable investment interest deduction, such gains constitute ordinary income.

Question 3

Capital gains from long-term, midterm, "nonproductive", and "small business stock" assets are all subject to conversion to ordinary income by operation of former Section 17203(d)(5). There is nothing to suggest that any priority exists with respect which gains and losses are to be applied for purposes of former Sections 17203(d)(1)(C) and 17203(d)(5). Accordingly, the appropriate method for determining the assets to be converted to ordinary income is determined by proration. Legal Ruling 378, *supra*.

For the purpose of determining which capital assets are converted into ordinary income assets under former Section 17203(d)(5), the following mechanics are to be applied:

- a) Gains in each of the described classes are netted against losses in that class (if applicable).
- b) Net losses from the classes exhibiting such loss are totaled, then prorated against the gains in the remaining classes.
- c) The total investment interest allowed by operation of Section 17203(d)(1)(C) is then prorated against the net gains resulting from step (b) above.

This can be illustrated by the following example:

1. Assume that a taxpayer has the following items:

a. Investment Interest (Attributable to debt incurred between 12/16/69 and 9/10/75)		\$50,000
b. Specific Exemption	\$25,000	
c. Net Investment Income	<u>5,000</u>	
d. Offset	<u>\$30,000</u>	<u>30,000</u>
e. Investment Interest After Offset		<u>\$20,000</u>
f. Midterm Capital Gain	\$10,000	
g. Midterm Capital Loss	(20,000)	
h. Long Term Capital Gain	40,000	
i. Long Term Capital Loss	(20,000)	
j. Nonproductive Asset Gain	5,000	
k. Small Business Stock Gain	<u>15,000</u>	
l. Former Section 17203(d)(1)(C) Amount (f through k)	<u>\$30,000</u>	

2. After netting or gains and losses in the same class the taxpayer has the following former Section 17203(d)(1)(C) items:

a) Net Midterm capital loss	\$(10,000)
b) Net Long-term capital gain	20,000
c) "Nonproductive asset" gain	5,000
d) "Small Business Stock" gain	<u>15,000</u>
	<u>\$30,000</u>

3. The \$10,000 net loss in the midterm capital loss class is prorated against the gains in other categories as follows:

Long Term Gains	\$20,000	-	$(\$10,000 \times 20,000)/40,000$	=	\$15,000
"Nonproductive asset" gains	5,000	-	$(\$10,000 \times 5,000)/40,000$	=	3,000
Small business stock" gains	15,000	-	$(\$10,000 \times 15,000)/40,000$	=	12,000
	\$40,000	-	\$10,000	=	\$30,000

4. Because only \$20,000 of investment interest remains to be applied against the net \$30,000 gain, the above stated gains are further prorated, as follows:

Long Term Gains	\$15,000	x	$\$20,000/30,000$	=	\$10,000
"Nonproductive asset" gains	3,000	x	$20,000/30,000$	=	2,000
"Small business stock" gains	12,000	x	$20,000/30,000$	=	8,000
	<u>\$30,000</u>	x	$20,000/30,000$	=	<u>\$20,000</u>

Accordingly, \$10,000 of long-term capital gains, \$2,000 of gains from "nonproductive assets," and \$8,000 of gains from the sale of "small business stock" will be treated as gains from the sale of ordinary income assets.

Question 4

Former Section 17203(d)(2)(B) and Section 17203(e)(3) together provide that if a taxpayer has investment interest from indebtedness attributable to a specific item of property incurred after December 16, 1969 and before September 10, 1975 that was carried over from a previous year and not utilized in the current year, the subsequent carryover of such amount would be reduced by the amount of capital gains not recognized in the current year by operation of Section 18162.5.

Because of the fact that former Section 17203(d)(2)(B) has current operative effect by reason of Section 17203(e)(3), and because "small business stock" and "nonproductive assets" are not taxed in whole or in part by operation of Section 18162.5, the untaxed gains from such assets will, along with other untaxed capital gains, reduce the available carryforward of such investment interest to the subsequent year, to the extent of such untaxed gains.

Question 5

Section 163(d)(3)(E), IRC, which defines this term "disallowed investment interest" for federal purposes, provides that the carryforward of

"disallowed investment interest" is the amount not allowable as a deduction solely by reason of the limitation in 163(d)(1) (and in earlier years by 163(d)(2)(A)). This phrase has been interpreted to limit the availability of investment interest carryover to the extent that such disallowed investment interest exceeds the taxpayer's taxable income for the year. See General Explanation of the Tax Reform Act of 1969, Staff of the Joint Committee of Internal Revenue Taxation (1970), page 100; Mertens, Law of Federal Income Taxation, Vol. 4A, Section 26.13b.

The apparent rationale for this interpretation is that a taxpayer should not be able to benefit from the carryover of investment interest if the investment interest would not have produced a tax benefit if allowed in full in the year paid or incurred.

Because Section 17203(d)(3)(E) (current and former) was patterned after Section 163(d)(3)(E) (current and former), California will apply a taxable income limitation on the carryover of disallowed investment interest in a manner similar to that applied for federal purposes.

This ruling modifies, in part, Legal Ruling 378, CCH para 205-173, P-H para. 58,626.